



## **REVIEW OF THE SYSTEM OF INTERNAL CONTROL**



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## Table of Contents

	Page
Introduction .....	1
Background.....	1
Vacant Positions .....	2
Risk Assessment.....	3
Evaluation of Risks and Controls .....	4
Conclusion .....	10

## **Introduction**

In accordance with the Financial Integrity and State Managers Accountability (FISMA) Act of 1983, the Employment Development Department submits this report on the review of its system of control for the biennial period ended December 31, 2011.

Under FISMA, the Employment Development Department (EDD) Director is responsible for establishing and maintaining a system or systems of internal accounting and administrative control within EDD. In turn, EDD management is responsible for establishing, maintaining, and evaluating adequate internal controls.

This report is prepared within the format provided by the Department of Finance, Office of State Audits and Evaluations. Should you have any questions, please contact:

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## **Background**

The EDD is a department within the California Labor and Workforce Development Agency. The EDD's mission is to promote California's economic growth by providing services to keep employers, employees, and job seekers competitive. The EDD offers a wide variety of programs, resources, and services to millions of Californians under the Employment Services, Unemployment Insurance (UI), State Disability Insurance (SDI), Workforce Investment, and Labor Market Information programs. In addition, EDD handles the audit and collection of payroll taxes and maintains employment records for more than 17 million California workers. One of the largest departments in State government, EDD has thousands of employees located at hundreds of service locations throughout the state.

The EDD promotes California's economic growth by providing services to keep employers, employees, and job seekers competitive. Following federal and State laws with fairness and equity, and ensuring fiscal integrity, EDD:

- Operates the State's employment service – connecting employers with job seekers.
- Acts as an economic stabilizer through the administration of the UI program.
- Provides prompt and accurate services that enable taxpayers to easily report data and meet their tax responsibilities.

- Minimizes the financial impact of non-occupational disabilities through the administration of the SDI program.
- Provides partial wage replacement when workers must care for a seriously ill family member or bond with a new minor child.
- Encourages self-sufficiency in the current and future workforce.
- Serves as the central source for information on California's labor market.
- Plans, deploys, and manages technology to improve its business processes and access to its services.

The EDD's strategic plan, "Planning for Organizational Success," includes five strategic goals:

**GOAL I:** Improve access to services and information through the use of information technology (IT) and partnerships.

**GOAL II:** Develop an integrated approach across EDD to improve customer satisfaction with EDD services.

**GOAL III:** Improve business processes to enhance results and reduce costs.

**GOAL IV:** Build human resource capacity so that staff has the skills necessary to meet the challenges of the changing environment.

**GOAL V:** Ensure the integrity of EDD's programs, services, and information assets.

These goals help employees, customers, and interested parties better understand EDD's priorities, opportunities, and challenges. These goals also help guide actions that EDD will take over the next several years to ensure it maintains the ability to deliver consistent and quality services to its customers.

**Vacant Positions** As statutorily required, EDD is in compliance with Government Code (GC), Section 12439. Our compliance includes working with the Department of Finance to eliminate unneeded vacant positions from the EDD budget. In addition, EDD has established new guidelines for managing vacant positions consistent with Assembly Bill 3000 (Chapter 1124, Statutes of 2002) which amended GC, Section 12439.

## **Risk Assessment**

The Department of Finance specifically requires that each department's FISMA report addresses the approach taken to performing an organizational wide risk assessment and that it includes the results of that assessment.

In 2011, the EDD Directorate and Executive Management Team completed a departmental risk assessment that identified five enterprise-level risks in three broad risk categories. These risks could impact the EDD's achievement of its goals and critical business objectives and are summarize below:

### Customer services risk

Inability to meet our customers' expectations.

### Human resources risk

Inability to maintain an adequate EDD workforce to carry out our mission.

### Information technology risks

- Catastrophic failure of IT systems results in our inability to meet our mission.
- Inadequate IT resources to support the existing and future service models and project portfolio.
- Failure to successfully complete our existing projects.

To complete this risk assessment, the EDD Directorate and Executive Management Team met in a series of meetings to compile, refine, and ultimately finalize both enterprise risks and mitigating controls.

First, the group compiled a listing of significant risks facing EDD in terms of achieving its critical business objectives. These initial risks were grouped into risk categories and then prioritized.

Second, the group eliminated duplicate risks and consolidated similar risks. This consolidation resulted in five final risk statements which were identified as reflective of EDD's most significant vulnerabilities. Risk owners within EDD were also identified at this stage in the process.

Third, the group consolidated and clarified control statements for the customer services and human resources risks. At the same time, the control statements for the IT risks were prepared by the IT risk owner.

Fourth, and finally, the group reviewed and discussed the risk assessment information and finalized the controls identified to mitigate risk impact. The group also assessed risk appetite and determined the priorities for implementing any new controls.

## **Evaluation of Risks and Controls**

As described previously, the EDD Directorate and Executive Management Team group identified five significant risks facing the department and the associated controls needed to mitigate those risks to an acceptable level. The group determined that EDD had existing controls in place and operating to effectively manage these risks. However, the group decided that EDD could further mitigate these risks by implementing additional controls. The significant risks and corrective action plans for implementing the additional controls are listed below.

Risk #1: Inability to meet EDD's customer expectations. This includes not effectively educating customers on what EDD can and cannot do, along with educating customers on what EDD is doing.

In addition, to maintain existing controls to address this risk, EDD will implement additional controls through 2013 including the following:

- EDD will continue to expand and improve its Web presence to ensure that marketing materials, news releases, and media-related information and content on the public Web site is current, consistent, accurate, and user friendly for the employer and individual customers.
- EDD will continue to expand self-service options including the Electronic Benefit Payments and Workforce Services Network projects.

Risk #2: Inability to maintain an adequate EDD workforce to carry out its mission. This includes the inability to develop a skilled workforce to provide mission-critical services and develop future leaders.

In addition, to maintain existing controls to address this risk, EDD will implement additional controls by mid-2012 including the following:

- Each branch will complete a Workforce Plan which focuses on specific branch needs, while complimenting and supporting the EDD Workforce Plan. These plans will address staff

recruitment/retention, leadership and staff development, and knowledge management.

- EDD will complete and roll out Workforce Plan initiatives.
- EDD will continue to update source documents and resources to build internal capacity and provide EDD customers (managers, supervisors, and staff) with personnel/management tools and resources. These efforts will be in partnership with other agencies including the Department of Personnel Administration, the State Controller's Office, and the State Personnel Board in addition to California State employee labor unions.

Risk #3: Catastrophic failure of our IT systems (hardware/software) results in our inability to meet our mission.

Risk #4: Inadequate IT resources to support the existing and future service models and project portfolio.

Risk #5: Failure to successfully complete existing projects jeopardizes EDD's credibility, its ability to take on future projects, and its existing financial investments.

In addition, to maintain existing controls to address these three risks, EDD will develop an IT Application and Technology Plan that will be incorporated into the Capital Plan and the next phase of EDD's project portfolio by the end of 2011.

### **Other Control-Related Actions**

The EDD takes multiple actions to ensure it has a strong system of control over its programs and operations consistent with the model promulgated by the Committee of Sponsoring Organizations (COSO). COSO defined internal control as a process that is affected by EDD's employees, including management and other personnel. This process is designed to provide reasonable assurance that EDD achieves its objectives of reliable financial reporting, effective and efficient operations, and compliance with applicable laws and regulations. These objectives and the COSO model are consistent with FISMA requirements.

The COSO model identifies five essential components of a strong system of control. The EDD effectively addresses each of these components in its system of control:

**Control Environment** – The control environment sets the tone of an organization, influencing the control consciousness of its people. It is the foundation for all other components of internal control,



providing discipline and structure. Control environment factors include the integrity, ethical values, and competence of the entity's people; management's philosophy and operating style; the way management assigns authority and responsibility and organizes and develops its people; and the attention and direction provided by the Board of Directors.

**Risk Assessment** – Every entity faces a variety of risks from external and internal sources that must be assessed. A precondition to risk assessment is establishment of objectives, linked at different levels and internally consistent. Risk assessment is the identification and analysis of relevant risks to achievement of the objectives, forming a basis for determining how the risks should be managed. Because economic, industry, regulatory and operating conditions will continue to change, mechanisms are needed to identify and deal with the special risks associated with change.

**Control Activities** – Control activities are the policies and procedures that help ensure management directives are carried out. They help ensure that necessary actions are taken to address risks to achieve the entity's objectives. Control activities occur throughout the organization, at all levels and in all functions. They include a range of activities as diverse as approvals, authorizations, verifications, reconciliations, reviews of operating performance, security of assets, and segregation of duties.

**Information and Communication** – Pertinent information must be identified, captured, and communicated in a form and timeframe that enable people to carry out their responsibilities. Information systems produce reports containing operational, financial, and compliance-related information that make it possible to run and control the business. Personnel deal not only with internally generated data, but also information about external events, activities, and conditions necessary to ensure informed business decision-making and external reporting. Effective communication also must occur in a broader sense, flowing down, across, and up the organization. All personnel must receive a clear message from top management that control responsibilities must be taken seriously. They must understand their own role in the internal control system, as well as how individual activities relate to the work of others. They must have a means of communicating significant information upstream. There also needs to be effective communication with external parties such as customers, suppliers, regulators, and shareholders.

**Monitoring** – Internal control systems need to be monitored--a process that assesses the quality of the system's performance over time. This is accomplished through ongoing monitoring activities, separate evaluations, or a combination of the two. Ongoing monitoring occurs in the course of operations. It includes regular management and supervisory activities, and other actions personnel take in performing their duties. The scope and frequency of separate evaluations will depend primarily on an assessment of risks and the effectiveness of ongoing monitoring procedures. Internal control deficiencies should be reported upstream, with serious matters reported to top management and the Board of Directors.

Following are highlights of some control-related actions taken by EDD over the past two years to ensure it maintains a strong system of control over its programs and operations:

### **Branch-Level Risk Assessments**

In addition to the enterprise-level risk assessment, EDD completed eight branch-level risk assessments during 2010. Branch-level risk assessments were completed for the Administration Branch; Disability Insurance Branch; Information Technology Branch; Policy, Accountability and Compliance Branch; Public Affairs Branch; Tax Branch; Unemployment Insurance Branch; and Workforce Services Branch. These branch-level risk assessments help Deputy Directors identify and manage their branch's specific programmatic risks.

The methodology used to complete the branch-level risk assessments followed the same basic steps as the enterprise-level assessment. Each branch management team and subject matter experts:

- Identified their branch's critical business objectives and the risks which could prevent the accomplishment of these objectives.
- Prioritized their branch's critical business objectives and ranked their risks.
- Ranked their top five critical IT systems.
- Identified controls which will mitigate the identified risks including controls currently in place as well as new controls to be implemented within 12 months.
- Developed action plans to mitigate identified risks to an acceptable level.

### **Internal Control Self-Assessments**

As in previous biennial periods, EDD executed an internal control self-assessment across the Department. In 2011, this self-assessment was distributed to 290 cost centers within EDD and was completed by managers throughout the Department. The EDD facilitated completion of the individual cost center self-assessments by utilizing an electronic data collection application.

The EDD's internal control self-assessment tool takes the form of a checklist comprised of a series of questions on whether specific internal controls are in place and, if control deficiencies are found, whether corrective actions are planned. The checklist includes sections on: personnel; equipment and supplies; buildings and facilities; information security awareness; IT security and risk management; disbursements and remittances; and record retention. The master checklist distributed to all EDD branches contains 120 questions which are supplemented for each branch with additional internal control questions covering their specific business processes.

The self-assessment process provides valuable information on the adequacy of internal controls throughout EDD. Individual cost center results are rolled-up by their respective branch and for EDD as a whole. The results are reported to the Chief of EDD's Audit and Evaluation Division (A&ED). The A&ED then independently validates the self-assessment results and corrective actions planned and taken as part of fulfilling its internal audit responsibilities.

### **Internal Audits - Control Segment Audits**

The A&ED serves as EDD's internal auditor and conducts a variety of audits, reviews, and evaluations throughout EDD. This internal audit function further strengthens EDD's internal controls as a part of the COSO monitoring component of internal control.

The A&ED conducts control segment audits as part of its internal audit responsibilities. These audits are designed to look at internal controls within specific business functions or processes.

The basic objectives of these control segment audits are to answer the following questions for a specific EDD business process:

- Are the internal controls for this business process designed to achieve the intended business results?
- Are the critical internal controls operating as intended?

- Do the resulting transactions satisfy the intended business results?
- What changes would improve the efficiency or effectiveness of this business process?
- Have any prior audit findings related to this business process been corrected?

Since being initiated in 2011, control segment audits have encompassed processes relating to payroll receivables, revolving fund travel advances, facility lease payments, subsidized transit sales, and the budget cycle. The A&ED plans to complete 10 to 12 control segment audits each year in the future.

### **“Tone at the Top”**

The EDD completed a “Tone at the Top” assessment in 2010 which provided information about the Department’s control environment. This assessment was accomplished by surveying all rank and file employees, supervisors, and managers to obtain their input on EDD’s work culture and environment. The Tone at the Top Survey provided participants with an opportunity to assess the environment in which they operate.

The purpose of conducting the Tone at the Top Survey was to:

- Identify the organizational climate and culture that is conducive to meeting EDD’s mission, vision, and business goals.
- Determine the degree of importance that management and administrators place on their branch’s programs, activities, and policies.
- Determine the degree to which the EDD Strategic Plan 2007-11 has been incorporated into the programs, activities, and policies of the branch.
- Measure EDD’s success in improving its work culture and environment with the new Employee Exit Survey.

Significant findings from this assessment confirmed that EDD has a control environment that supports strong internal control. Three broad findings specifically related to EDD’s control environment were identified:

- A majority of employees and leaders agreed that EDD’s and branches’ mission statements, fundamental values, and expectations are clearly communicated by management. Further, an overwhelming majority of employees agreed that their supervisors conduct business in an ethical, honest, and fair manner.

- A majority of employees and leaders agreed that management used resources wisely.
- A majority of employees and leaders agreed that they can report misconduct without fear of retribution and had not witnessed violations of codes, policies, or procedures during the past year.

### **Electronic Benefit Payment Contract with Bank of America**

The EDD began implementing the Electronic Benefit Payment (EBP) system in 2010 which enables issuing benefit payments to claimants using an EDD debit card. The EBP project is part of the EDD's continuing automation efforts to provide benefits to eligible claimants more efficiently and, when fully implemented, SDI, Paid Family Leave, and UI benefit payments will no longer be issued by check. The EDD contracted with Bank of America for the EBP project.

The move from benefit checks to debit cards will ultimately extend EDD's system of controls to include those over the administration of the EDD debit card. The EDD's contract with Bank of America includes comprehensive programmatic, fiscal, and operational requirements to ensure strong controls exist over the EBP system and service delivery. The EDD also has established provisions for departmental audits of the system and services in addition to an annual Statements on Auditing Standards #70 service organization audit covering continuity, fraud, security, and reconciliation.

### **Conclusion**

Based upon the results of its internal review, risk assessments, and results of both internal and external audits, it was determined that the EDD's system of control is adequate to ensure that the Department achieves its objectives of reliable financial reporting, effective and efficient operations, and compliance with applicable laws and regulations.

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The California State Employment Development Department is a recipient of federal and State funds, is an equal opportunity employer/program, and is in compliance with Section 504 of the Rehabilitation Act and the Americans with Disabilities Act.

Special requests for alternate formats need to be made by calling (916) 654-7000.